



# State of Hawaii Tax Review Commission

## PFM Draft Report

**Presented by Randall Bauer and Dr. Christopher Wheeler**

September 12, 2017

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## Discussion Topics

- Study Introduction
- Draft Report Status (including Commission Comments)
- Study Contents
  - Current Revenue Structure
  - Tax Burden
  - Tax Regressivity
  - Possible Revenue Changes
  - Observations and Recommendations
- Next Steps



# Study Introduction



## Project Focus

- Three primary areas for study:
  - Who bears the burden of Hawaii's taxes (including how much is exported to visitors)?
  - What are the most effective ways to reform Hawaii's taxes to make them less regressive?
  - What are the best ways to generate more revenue through new and existing sources, and through improved compliance with Hawaii's tax laws?
- Used 2012 Report as a Starting Point, but all Benchmarking and Analysis was Updated through FY2016



## Project Activities

- Kick-off and Detailed Project Interviews (February-March)
- Data Collection, Review and Analysis (March-May)
- Other State Benchmarking (April)
- High-Level Findings and Discussion (June-July)
- Draft Report (August-September)
- Final Report (September)



# Draft Report Status



## Draft Report Status

- Draft Report Provided to the Commission on August 7, 2017
  - Brief discussion with the Commission at its meeting on August 10, 2017
  - Additional items identified for inclusion in the final report, primarily related to pension funding needs
- Commission Comments Provided to PFM on September 6, 2017
- PFM Responses to Comments Provided on September 11, 2017
- Based on Feedback at this Meeting, PFM will Provide Final Report Before the End of the Month



## Draft Report Commission Commentary

- Helpful Feedback/Questions from Commissioners Takamura, Cook and Knox and TRC Writer/Researcher Dr. Rousslang
  - Written responses provided on September 11, 2017
  - Many of the comments/questions/suggestions will be incorporated into the final report
- Specific Areas of Additional Focus/Discussion include:
  - Chapter specific introductions and summaries
  - Better tie together the discussion around themes of tax burden and regressivity
  - Improve clarity/focus for those with limited subject matter expertise
- Happy to Discuss Any Specific Areas Related to the Commentary or From Remaining Commission Members





# **Study Contents: Current Revenue Structure**

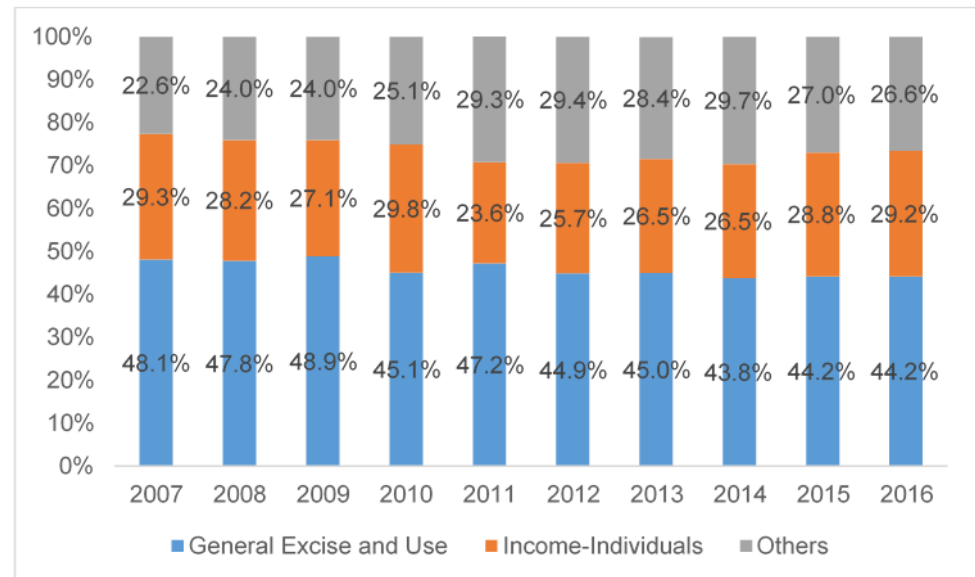


## Current Revenue Structure

### ■ Primary Reliance on Two Major Sources and Types of Tax

- General Excise Tax (GET) – approximately 44 percent of All-Funds revenue
- Individual Income Tax – approximately 29 percent of All-Funds revenue
- Together, nearly three-fourths of All-Funds revenue, 86 percent of General Fund revenue
- Next largest revenue source, TAT, accounts for less than 4 percent of All-Funds revenue

**Hawaii Tax Revenue Composition (All Funds), 2007-2016**





## **Current Revenues: Relatively Stable Major Sources**

- Since the Great Recession, No Major Revenue Changes to Balance Its General Fund Budget
- General Excise Tax is a Uniquely Broad-Based State Tax
  - A business privilege tax applied to a business's gross receipts
  - Applies to the vast majority of business activities
  - More broad than even the most broad state sales tax (in terms of being applied to services and business inputs as well as finished goods)
- Individual Income Tax is Highly Progressive
  - More brackets than most state individual income taxes
  - Marginal brackets 'kick-in' at lower income levels than in many states
  - Top bracket is second highest in the U.S.
  - Major change in 2017 with adoption of a State Earned Income Tax Credit



## No Real ‘Third Leg’ for the Three-Legged Stool

- Historically, Corporate Income Taxes were the Third Leg in Many States, but that Has Changed/Is Changing
  - Highly volatile, susceptible to tax planning
    - Income apportionment
    - Ability to carry forward (and backward) for profits/losses and credits
  - Has become a much smaller percentage of overall collections
    - In many states, the traditional three factors (sales, property and payroll) for apportioning a business’s share of profits to that state has been modified – generally to add extra weight to sales
    - States also provide a variety of specific exemptions and credits that can reduce taxable corporate income
  - Has led to a re-thinking of its value in several states – including the research done by Dr. Rousslang for the Commission
- No Other Hawaii General Fund Revenue Source Totals Even 10 percent



# Revenue Structures and State Economies

- States Seek Ways to Tax Their Natural Resources
  - Mineral Extraction Taxes (helps explain lack of income taxes in Alaska, Texas and Wyoming)
  - States with high per capita personal income or median household income generally apply a progressive individual income tax
    - These include states like Maryland, Connecticut, New Jersey – and Hawaii
    - Hawaii second highest median household income in 2016
- Tourist Taxes is a Logical Method to Tax Consumption of Hawaii's Natural Resources
  - TAT/TOT
  - GET and other Excise Taxes (motor fuel, tobacco, alcohol, rental cars, etc.)
  - Concern as to whether high taxes might reduce economic activity



# **Study Contents: Tax Burden**



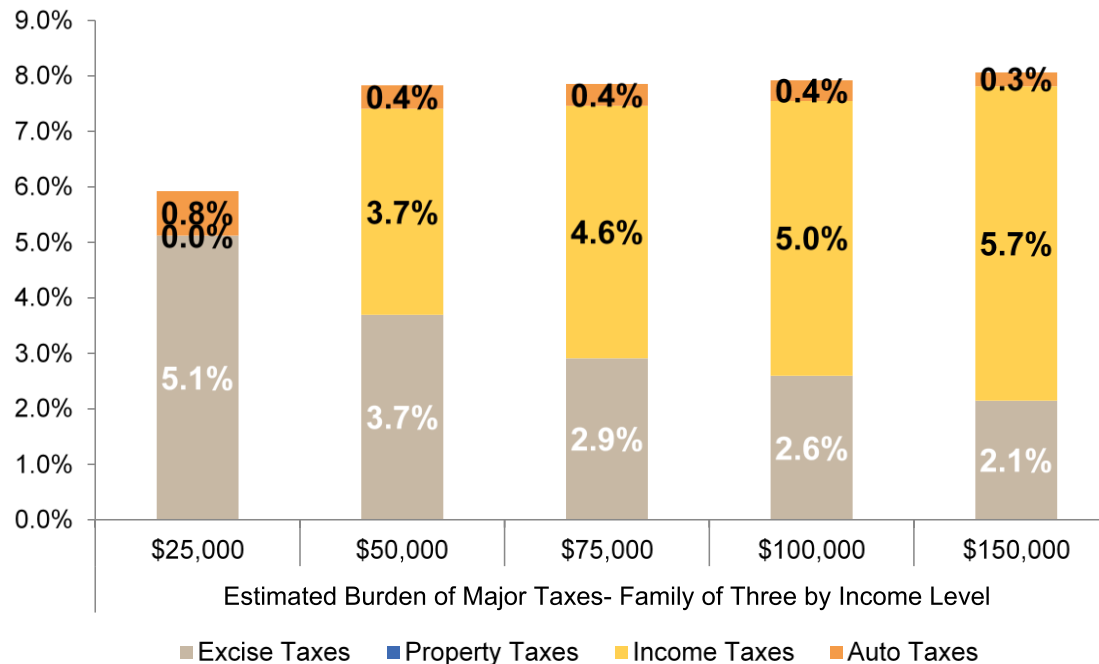
# Tax Burden Calculation Methodology

- Based on a Typical Family-of-Three at Differing Income Levels
  - Estimates actual taxes paid at 5 income levels (\$25,000, \$50,000, \$75,000, \$100,000 and \$150,000) using national BEA data on household consumption
  - Similar to a study done annually by the Chief Financial Officer for Washington DC
  - Allows benchmarking comparisons to the largest city in all 50 states
- Differs from State Studies that use Aggregate Personal Income and State Taxes Paid
  - A major difference is the issue of exported tax revenue burden, as the aggregate method doesn't generally remove these taxes from the analysis
  - Given the focus on exporting tax burden, that is an important distinction for Hawaii
  - Some of these studies also do not combine state and local taxes – given the mix of state responsibilities for local funding (particularly in Hawaii) this can also create 'false positives'
- A disadvantage is that the benchmark comparisons are for cities rather than states as a whole



# Overall, Hawaii's Tax Structure is More Progressive Than Regressive

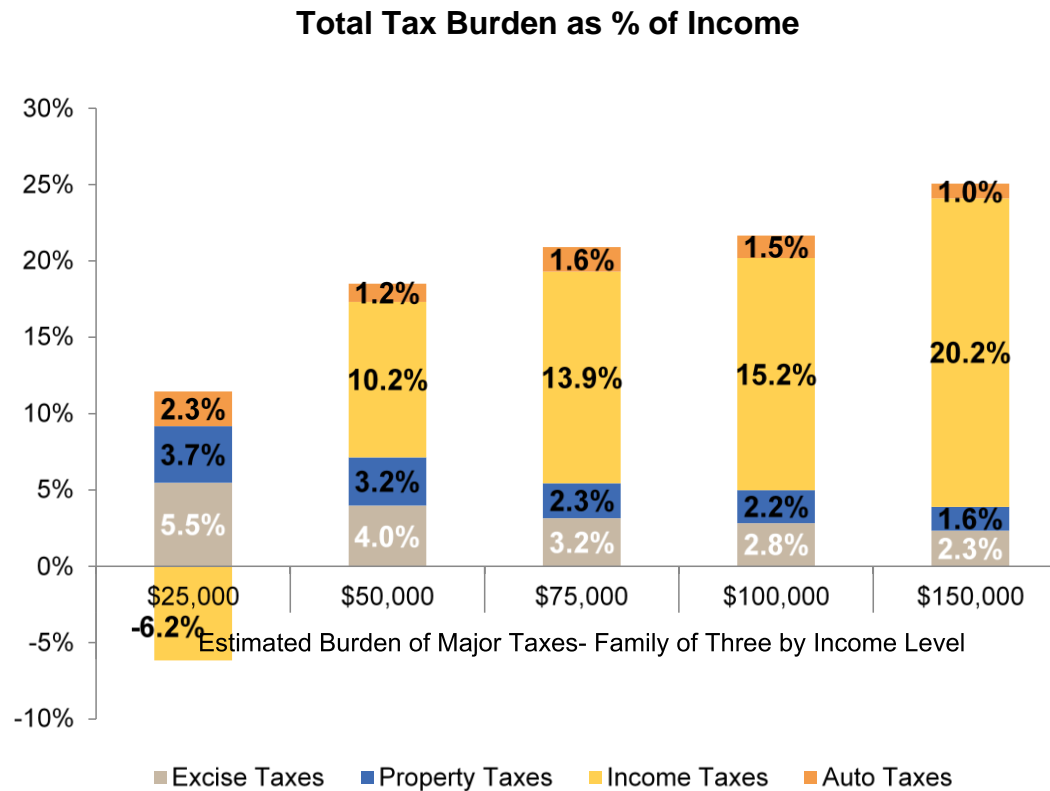
State Tax Burden as a % of Income







# Including Federal and Local Taxes, Hawaii's Tax Structure Becomes More Progressive





# Exported Tax Revenue: Past Study Findings

## General Excise Tax Burden by Taxpayer Type

Share of General Excise Tax					
Study	Residents/ State and Local Gov't	Federal Gov't	Tourists	Nonresident Business and Property Owners	All Nonresidents (Tourists + Owners)
Mikius, Moncor, and Leung (1988)	66.4%	1.8%	21.9%	9.8%	31.7%
Bowen and Leung (1989)	66.7%	2.3%	25.0%	6.0%	31.0%
2006 DOTAX Study	62.1%	6.3%	--	--	31.6%
PFM (2017)	--	--	19.0%	--	--
<b>Study Average</b>	<b>65.1%</b>	<b>3.5%</b>	<b>22.0%</b>	<b>7.9%</b>	<b>31.5%</b>

## Total State and Local Tax Burden by Taxpayer Type

Share of All State and Local Taxes					
Study	Residents/ State and Local Gov't	Federal Gov't	Tourists	Nonresident Bus. and Prop. Owners	All Nonresidents (Tourists + Owners)
Mikius, Moncor, and Leung (1988)	67.5%	7.2%	16.1%	9.3%	25.4%
Bowen and Leung (1989)	67.9%	2.3%	22.0%	7.8%	29.8%
2006 DOTAX Study	68.5%	9.6%	--	--	21.9%
<b>Study Average</b>	<b>67.9%</b>	<b>6.4%</b>	<b>19.1%</b>	<b>8.5%</b>	<b>25.7%</b>



# PFM Estimate on Tourist GET Burden

## ■ Methodology

- Used 2016 Hawaii Tourism Authority (HTA) data and GET collection data from the Council on Revenues
- Used HTA statistics on visitor days and air visitor personal daily spending and actual GET collections for 2016

## ■ Estimate: Tourists (excluding non-resident owners and the federal government) currently account for 19.3 percent of State GET collections (excluding the Oahu surcharge)

- Slightly lower figure than many previous estimates
- Closer to the figures from the Mikus, Moncor and Leung and Bowen and Leung studies
- The change in visitors' share of GET has fluctuated over time but has declined consistently since 2014.
- The following figure charts this over time based on total visitor days and personal daily spending



# PFM Estimate on Tourist GET Burden

## ■ Methodology

- Used 2004-2016 Hawaii Tourism Authority (HTA) data and GET collection data from the Council on Revenues
- Used HTA statistics on visitor days and air visitor personal daily spending and actual GET collections for 2004-2016

## ■ Estimate: Tourists (excluding non-resident owners and the federal government) account for 19.3 percent\* of State GET collections (excluding the Oahu surcharge)

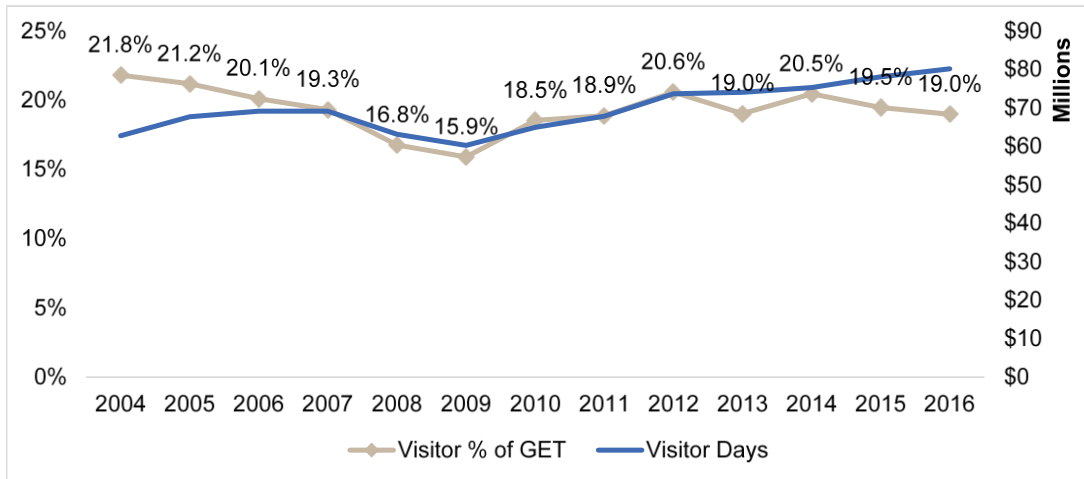
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\*2004-2016 historical average

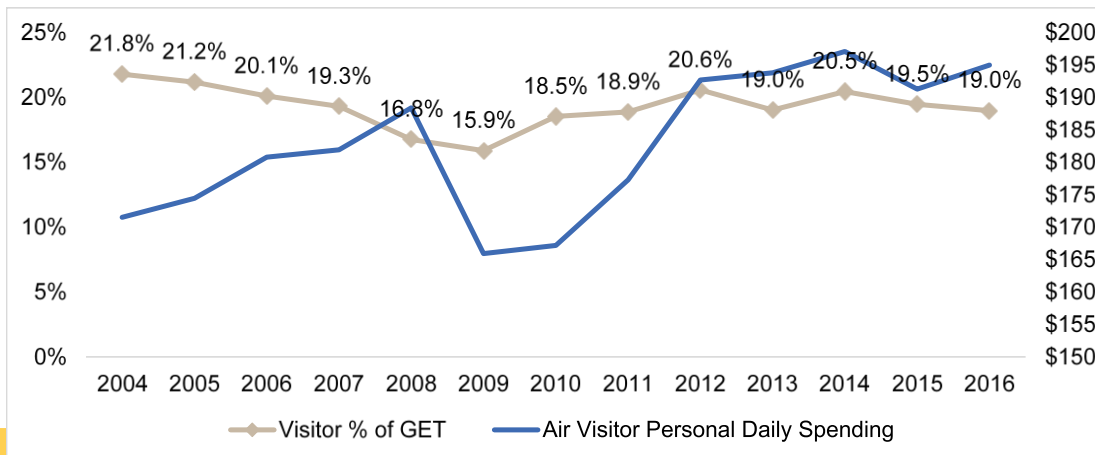


# PFM Estimate on Tourist GET Burden

Visitor % of GET vs. Total Visitor Days



Visitor % of GET vs. Personal Daily Spending





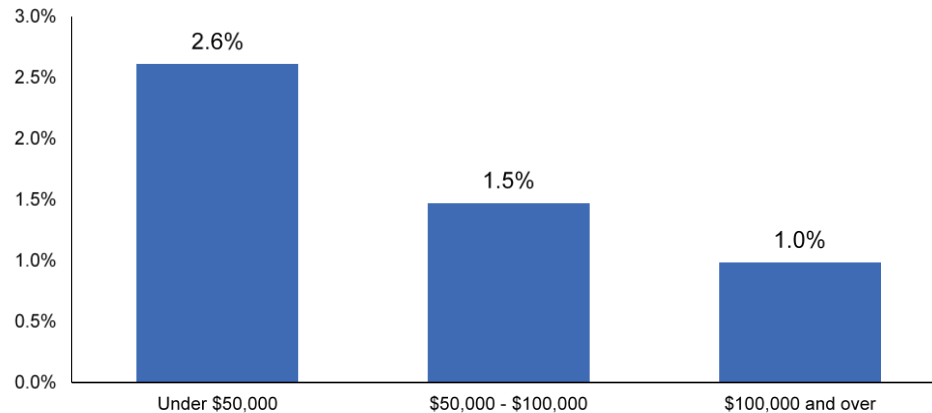
# **Study Contents: Tax Regressivity**



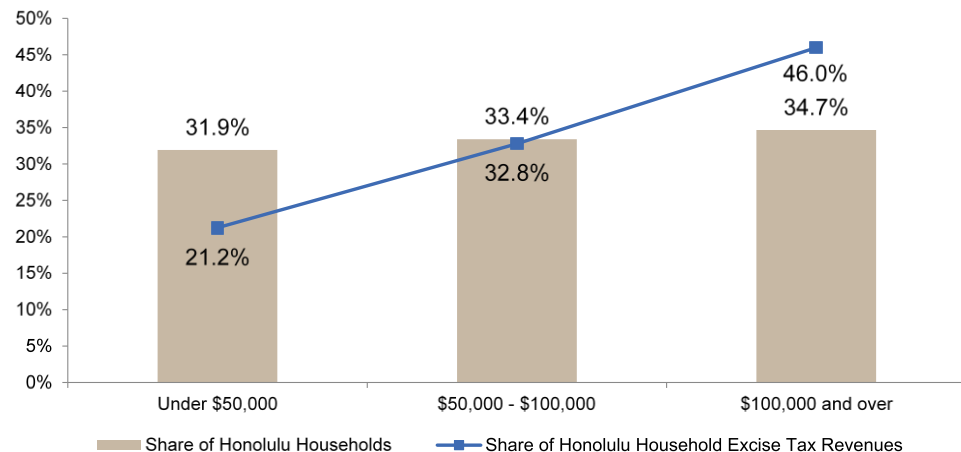
## General Observations on Regressivity

- The State's largest revenue source, the GET is regressive
- In the aggregate, upper income taxpayers pay a disproportionate share of the GET

Ratio of General Excise Taxes Paid to Household Income by Income Range, 2014



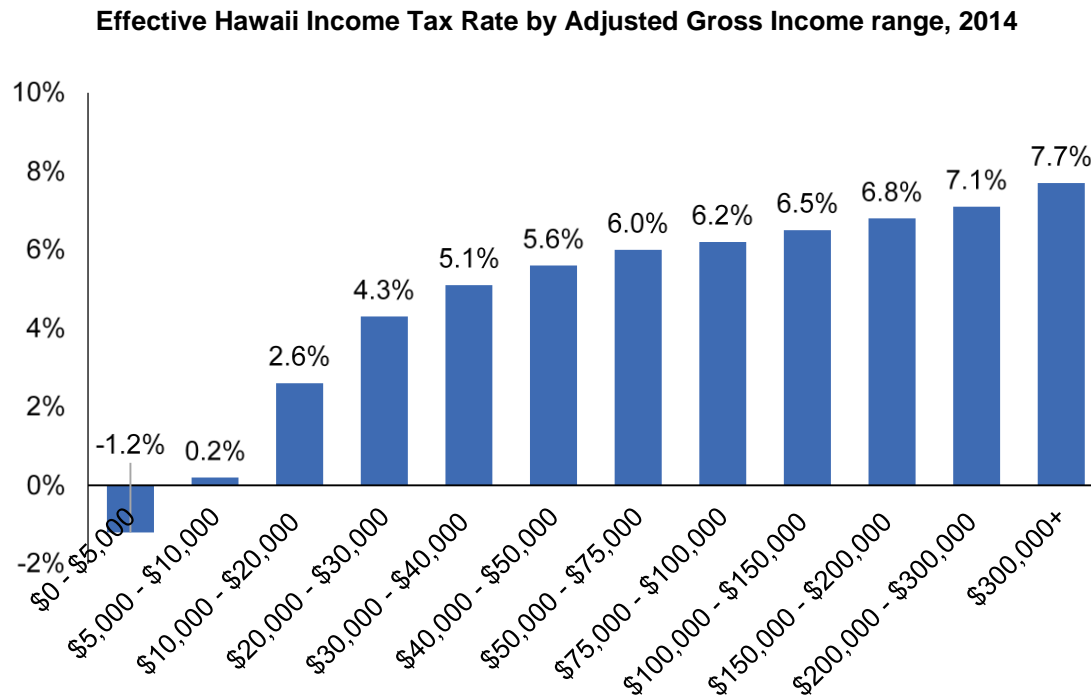
Share of Honolulu Households and Total Excise Tax Revenues by Income Range, 2013-2014





## General Observations on Regressivity

- The State's second largest revenue source, the Individual Income Tax, is broadly progressive



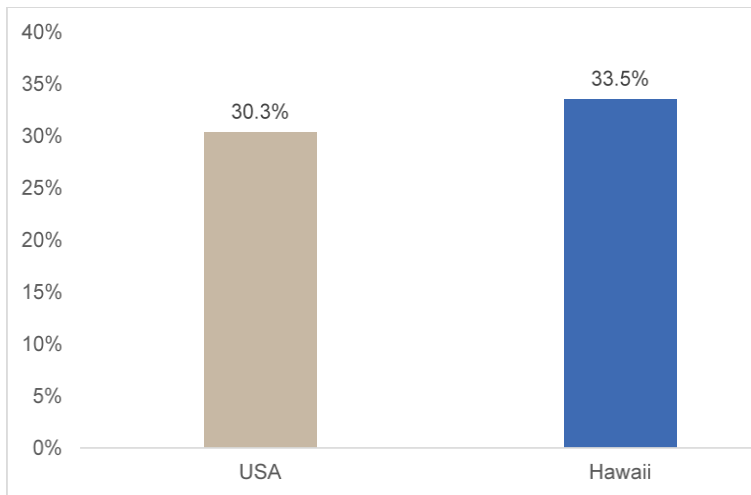
Source: Hawaii Department of Taxation, Hawaii Income Tax Statistics Tax Year 2014





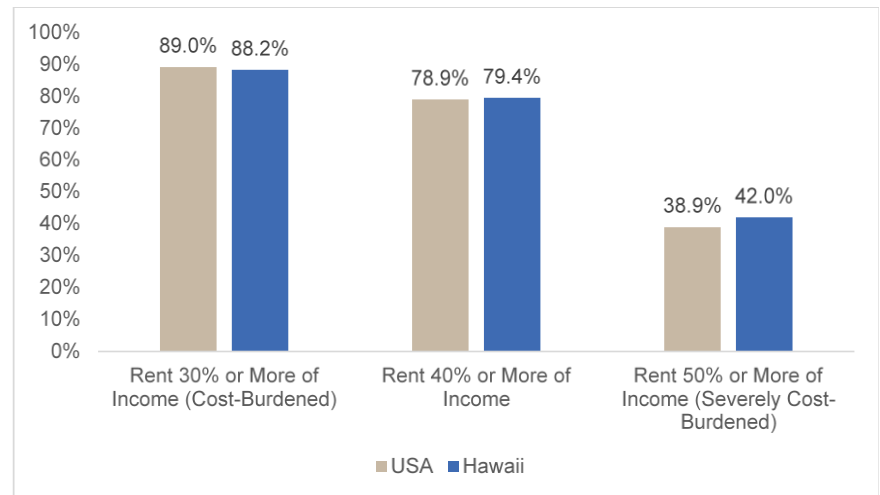
# Hawaii Renters are Cost Burdened

**Median Gross Rent as a % of HH Income, 2015**



Source: US Census Bureau, 2015 American Community Survey 1-Year Estimates

**% Rent Cost Burdened, Renter Households Making <\$20,000, 2015**



Source: US Census Bureau, 2015 American Community Survey 1-Year Estimates



# **Study Contents: Possible Revenue Changes**



# Possible Revenue Changes Overview

## ■ Alignment with Tax Policy Principles

- Tax Review Commission deliberations should be guided by such 'standards as equity and efficiency.'
- Commission focus on tax burden and regressivity also helped guide analysis on revenue changes
- Other principles, including stability, economic competitiveness and simplicity/ease of administration are also important

## ■ Recognition that There is No Perfect Tax

- All taxes will have some negative impact on economic activity
- There is a danger with new taxes that there will be unintended consequences
- There is a general acceptance that 'old taxes' have overcome these consequences and have been 'baked in' to market-based decisions
- "The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing."



# Additional Issues with Revenue Alternatives

- Trade-offs on Policy Goals
  - Tax principles will conflict
  - Differing economic impacts during different places in the business cycle
  - Differing impacts on types of taxpayers
- “Three Legged Stool” is Really About Complementary Taxes
  - Cyclical versus counter-cyclical taxes
  - Consumption, income and wealth taxes
  - Broad-based versus focused taxes
  - Non-tax revenue alternatives
- Varying Methods of Taxation
  - Create a new tax
  - Expand the base of an existing tax
  - Increase the rate of an existing tax
  - Increase taxpayer compliance with an existing tax



# Excise Tax Alternatives

- Slightly higher than national average for excise tax collections
  - Common revenue-raising measure among states and Hawaii – example cigarette tax
  - State's island status means that cross-border competition issues are mitigated
  - In many instances, Alaska and Hawaii are among the highest state excise tax rates
- Options
  - Increase cigarette and tobacco tax rates
  - Increase gallonage taxes on distilled spirits, wine and/or beer
  - Restore the surcharge on rental cars
  - Institute a tax on sugared beverages
  - Tax medical marijuana
  - Institute a carbon tax
  - Institute a Vapor/e-Cigarette tax
  - Increase the GET tax rate
  - Changes to TAT/TOT taxes – rates and/or how/where collected



# Income Tax Alternatives

- Individual Income Tax Alternatives Focus on Base Rather than Rate
  - Already higher than most states on marginal rates
  - Already highly progressive
- Corporate Income Tax Alternatives are the Focus of Separate Study
  - As a result, alternatives are provided but no recommendations are made
  - Corporate income taxes continue to be a declining revenue source, with few states moving in the opposite direction



# Income Tax Alternatives

- Reduce the Pension Exemption
  - Hawaii one of six states with broad-based individual income tax that fully exempts state and local pensions from tax
  - Remainder tax as ordinary income, often with some portion exempt, which ranges from \$2,000 (Delaware and West Virginia) to \$65,000 (Georgia)
  - Ten states provide no exemption for pension income
- Reduce the Exemption on Foreign (out-of-state) Pensions
- Implement a Personal Income Tax Rate Recapture



# Property Tax Alternatives

- **State Constitution Prohibits State Levy of a Property Tax**
  - Similar to most states – property tax is generally reserved for local governments
  - Property tax in Hawaii does not fund K-12 education, which is not the case in other states
- **Eliminate Deduction for Property Taxes Paid**
  - Actually an individual income tax change
  - Method to increase property tax burden, which is low among states
- **Shift a Portion of K-12 Expenses to Property Tax**
  - Technically, not a State tax issue
  - Would be a major change in State expenditure policy
  - Would also bring Hawaii more into the norm of other states (in terms of state-local relationship)





# Tax Compliance Alternatives

- State is Implementing a Major Tax System Modernization
  - System changes will often lead to some confusion/disruption in processes
  - Generally work themselves out in time, and tax obligations remain
  - State has an IV&V process and vendor responsible for that
  - Options reflect the fact that the system is in flux and that implementation completed
- E-Commerce Compliance is a Key State Issue Across the U.S.
  - States aggressively pursuing new definitions of nexus – economic nexus
  - Issue is likely to be resolved by the U.S. Supreme Court
- Use of Tax Gap Program
  - Opportunity to identify new revenue
  - Likely need to complete Tax System Modernization first
- Additional Audit Functions
  - Generally cost effective
  - Should complete Tax System Modernization first



# **Study Contents: Observations and Recommendations**



# Observations and Recommendations

- Future Lack of Revenue Sufficiency
  - Current business cycle – expansion cannot last forever
  - Likely reductions in federal support
  - Long-term federal/state/local budget concerns
  - State forecasts of moderate growth rates
- Framework for Weighing Options
  - Commission charge to consider tax principles, including equity and efficiency
  - Commission this time also focused on tax burden, regressivity and exporting revenue to visitors
- Report Identifies Alternatives
  - Some alternatives are not as fully analyzed
  - Ultimately, the decision rests with the Commission and the policymakers who will receive its recommendations



# Recommendations

## ■ Expand the Tax Base

- Reduce the pension exemption in the individual income tax
- Eliminate the deduction for property taxes paid
- Tax medical marijuana
- Institute a vapor/e-cigarette tax

## ■ Reduce Regressivity in Taxes

- Increase the standard deduction for individual income taxpayers
- Double the refundable food/excise tax individual income tax credit

## ■ Export Share of Tax Burden to Non-Residents

- Increase excise taxes on cigarettes, alcohol
- Changes to TAT/TOT taxes
- Restore surcharge on rental cars



## Recommendations (continued)

### ■ Economic Efficiency

- Institute a tax on sugary beverages
- Institute a carbon tax

### ■ Improve System Administration and Collections

- Develop tax gap systems to identify additional tax revenue owed
- Expand efforts to incent collection of GET from e-commerce transactions

### ■ No Recommendation

- Corporate tax changes
- Pension changes for foreign pension income
- Personal income tax rate recapture
- State earned income tax credit a refundable credit
- Shift K-12 expenses to property tax
- Additional audit programs



# Next Steps



## Next Steps

- PFM Will Revise Draft Based on Discussion and Direction
  - Written questions/comments from the draft report
  - Commission feedback from this presentation as well
- PFM Will Augment Based on the Additional Pension Obligations
  - Will increase the identified funding need
  - Can be accommodated within the revenue options already identified
- PFM Will Provide a Final Report to the Commission Within the Original Identified Timeframe



## RFP Required Milestones

Date	Description
1 <sup>st</sup> Week of February 2017	Contract Signed
2 <sup>nd</sup> Week of February 2017	Interviews TRC Members
3 <sup>rd</sup> Week of February 2017	Interviews Key Stakeholders
4 <sup>th</sup> Week of February 2017 or 1 <sup>st</sup> Week of March 2017	Attend TRC Meeting in Person to Discuss Project Plan and Strategy
4 <sup>th</sup> Week of August 2017	Draft Report Due
4 <sup>th</sup> Week of August 2017	Attend TRC Meeting in Person to Present Draft Report (Moved to September per Commission Request)
4 <sup>th</sup> Week of September 2017	Final Report Due





# Questions and Discussion